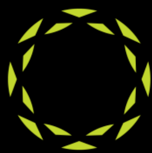


Folkestone

A GUIDE TO TAX DEFERRED INCOME IN UNLISTED REAL ESTATE FUNDS

JULY 2015

Unlisted real estate income funds are an attractive investment for investors seeking recurring income. These funds generate the majority of income from the rental income of the fund's underlying properties.

Distributions are typically paid monthly or quarterly to investors, part of which may include a tax deferred component. What is not well understood is the benefit of the tax deferred component of these distributions to investors, especially those on higher incomes or who invest through a SMSF or allocated pension.

WHAT ARE TAX DEFERRED DISTRIBUTIONS?

Tax deferred distributions arise when a fund's cash distributable income is higher than its net taxable income. The difference arises through tax allowances that can be claimed on the underlying real estate owned by the fund under the Income Tax Assessment Act 1997. The two most common capital allowances are:

1. plant and equipment (depreciating assets) under Division 40 of the Act;
2. building structures under Division 43 of the Act.

Certain borrowing costs and capital raising costs may also be claimed as tax deductions which can also increase the tax deferred component of a distribution.

The amount of the tax deferred component of a distribution will vary depending on a range of factors including the type and age of the asset held by the fund. New properties tend to have higher capital allowances than older properties, and therefore, a fund with a new property will tend to have a higher tax deferred component of the distribution.

The tax deferred component of the distribution is not assessed as taxable income when it is paid to the investor at their marginal tax rate but is instead applied as a reduction to the tax cost base of the investment (it does not lower the actual dollar amount invested in the fund) when calculating any Capital Gains Tax (CGT) liability. As a result, it maybe 'deferred' until the sale or redemption of an investor's units in the fund when CGT may be paid[1].

Therefore, the capital gain (the difference between the sale/redemption price and cost base) will be higher than otherwise would be the case if distributions did not contain any tax deferred component. The investor will have to pay capital gains tax, which if the units have been held for more than 12 months, will be at the concessional CGT rate.

For individual tax payers, this equates to a 50% discount, meaning only 50% of the gain is taxable at their marginal tax rate. Superannuation funds are entitled to a 33% discount and in some circumstances, can potentially treat the entire gain as tax free.

BENEFITS OF TAX DEFERRED INCOME FOR INVESTORS

There are a number of potential benefits depending on the individual circumstances of investors. These include:

1. the tax deferred component of the distribution is not taxed in the year of receipt, and therefore, an investor receives greater after tax cashflow during the investment term which can be used to reinvest in other investment opportunities. The compounding benefit from reinvesting this additional income can be significant;
2. the tax deferred income is only brought to account when an investment is sold[2] and therefore, is taxed as capital rather than income. Depending on the investor's marginal tax rate and length of time the investment is held, it may reduce the amount of tax that otherwise would have been paid if it was taxed as

[1] Note, if the aggregate tax deferred income reduces an investor's cost base to nil, the excess amount and any subsequent tax deferred distributions received are accessible as capital gains to the Unitholder in the year of receipt.

[2] Provided the total tax deferred income does not exceed an investor's cost base in the investment.

income in the year of receipt; and

BENEFITS OF TAX DEFERRED INCOME FOR INVESTORS CONT'D

3. for superannuation funds in the allocated pension phase, the capital gain maybe tax free. Even if the investment was made prior to the allocated pension phase, if the capital gain is realised in the allocated pension, the capital gain should be tax free, and therefore the investor will not have to pay any tax on the tax deferred component of the distributions.

How Does it Work?

We have prepared three scenarios based on an investor with the highest marginal tax rate holding the investment in their own name, holding it through their SMSF or in an allocated pension.

Highest Marginal Tax Rate

Let's assume that Peter has a marginal tax rate of 49%[3], and invests $10,000 for 10,000 units at $1 each into an unlisted real estate fund, that pays an annual distribution of 8% which is 50% tax deferred in each of the five years of the fund's life. At the end of fifth year, the fund is wound up and Peter receives $1.20 per unit or $12,000 for his units in the fund.

As shown in Table 1, if there is no tax deferred benefits, the total tax payable over the life of the fund (income and CGT) by Peter would be $2,450 compared to $1,960 if 50% of the fund's distributions were tax deferred. Peter is therefore $490 better off if the fund had 50% of the distributions tax deferred.

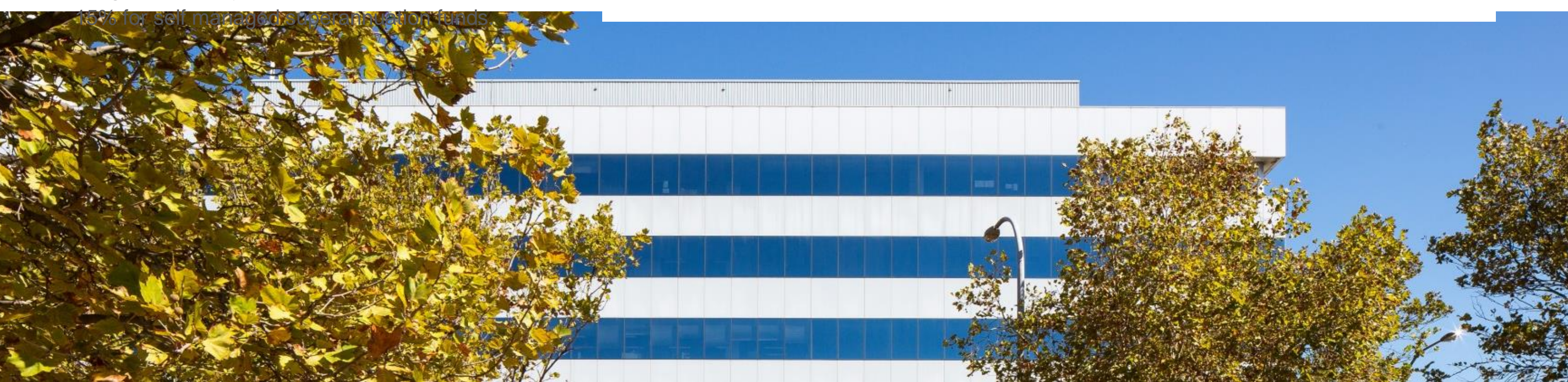
[3] Assumes the tax rates for the FY16 tax year of 45% plus the Medicare levy of 2% plus the budget repair levy of 2% for individuals and 15% for self managed superannuation funds.

Table 1 – Highest Marginal Tax Rate [3]

	Unlisted Real Estate Fund - No Tax Deferred Distributions Each Year $	Unlisted Real Estate Fund - 50% Tax Deferred Distributions Each Year $
Annual Income Distribution at 8% p.a.	800	800
Distributable Income Received Over Life of Fund (5 years * $800 p.a.)	4,000	4,000
Tax Deferred Component	0	2,000
Total Taxable Distributable Income Over Life of Fund	4,000	2,000
Income Tax Paid at 49% Over Life of Fund (A)	**1,960**	**980**
After Income Tax Cashflow	**2,040**	**1,020**
Proceeds From Wind-up of Fund	12,000	12,000
Tax Cost Base of Units in the Fund	10,000	8,000
Capital Gain at End of Fund Term	**2,000**	**4,000**
Capital Gains Tax Paid – 50% discount at 49% (B)	**490**	**980**
Total Tax Paid (Income and CGT) (A) +(B)	**2,450**	**1,960**

Table 2 – Self Managed Superannuation Fund [3]

	Unlisted Real Estate Fund - No Tax Deferred $	Unlisted Real Estate Fund - 50% Tax Deferred $
Annual Income Distribution at 8% p.a.	800	800
Distributable Income Received Over Life of Fund (5 years * $800 p.a.)	4,000	4,000
Tax Deferred Component	0	2,000
Total Taxable Distributable Income Over Life of Fund	4,000	2,000
Income Tax Paid at 15% Over Life of Fund (A)	**600**	**300**
After Income Tax Cashflow	**3,400**	**3,700**
Proceeds From Wind-up of Fund	12,000	12,000
Tax Cost Base of Units in the Fund	10,000	8,000
Capital Gain at End of Fund Term	2,000	4,000
Capital Gains Tax Paid – 33% discount at 15% (B)	**200**	**400**
Total Tax Paid (Income and CGT) (A) +(B)	**800**	**700**



BENEFITS OF TAX DEFERRED INCOME FOR INVESTORS CONT'D

Self Managed Superannuation Fund (SMSF)

Let's assume that Mary using her self managed superannuation fund (SMSF) invests $10,000 for 10,000 units at $1 each into an unlisted real estate fund, that pays an annual distribution of 8% which is 50% tax deferred in each of the five years of the fund's life. At the end of fifth year, the fund is wound up and Mary receives $1.20 per unit or $12,000 for his units in the Fund.

The SMSF pays 15%[3] tax on income and receives a 33% discount for capital gains.

As shown in Table 2, if there are no tax deferred benefits, the tax payable over the life of the fund (income and CGT) by Mary's SMSF would be $800 compared to $700 if 50% of the fund's distributions were tax deferred. Mary is therefore $100 better off if the fund had 50% of the distributions tax deferred.

Allocated Pension

If Mary receives her distributions during the accumulation phase in her SMSF and decides to retire and transfer the investment from her super fund to an allocated pension fund just prior to the end of the fund's term, the tax deferred amounts are still included in the CGT calculation. However, in an allocated pension, the CGT is taxed at a marginal rate of zero and therefore Mary would pay no tax on the either the tax deferred or the CGT component. Mary would save $400 in tax.

FURTHER INFORMATION

At the end of every financial year, Folkestone provides investors with an annual tax statement that details the components of the annual distribution including the tax deferred component. These statements should be retained so that an investor can complete their tax returns on an annual basis and calculate the capital gains tax at the time of disposal/redemption of their units.

The taxation of tax deferred distributions can be complex especially if the tax deferred component of a fund's distribution changes each year. The information above is intended to provide only general information in summary form on the treatment of tax deferred distributions. Investors should seek tax, legal or other professional advice specific to their own personal circumstances before acting or relying on any of the content.

ABOUT FOLKESTONE

Folkestone (ASX:FLK) is an ASX listed real estate funds manager and developer providing real estate wealth solutions. Folkestone's funds management platform, with more than $870 million under management, offers listed unlisted real estate funds to private clients and select institutional investors, while its on balance sheet activities focus on value-add and opportunistic (development) real estate investments.

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